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Auditor

BOARD OF SUPERVISORS:

NRG Energy Center
San Francisco LLC
Owes Additional Franchise Fees
for 2003 Through 2005

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CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER

Ed Harrington
Controller

Monique Zmuda
Deputy Controller

December 12, 2006

Audit Number 05039

Board of Supervisors
City Hall, Room 244
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102

President and Members:

The Office of the Controller presents its report on the review of franchise fees NRG Energy Center San Francisco LLC (NRG) paid to the City and County of San Francisco (City) to use city streets to install, construct, maintain, and operate steam pipe conduits. NRG is required to report annual gross receipts and to pay two percent of the gross receipts subject to the City's franchise fee. The City's Public Utilities Commission is responsible for overseeing the franchise.

Reporting Period: January 1, 2003, through December 31, 2005

Franchise Fees Paid: \$410,111

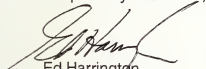
Additional Fees Owed: \$80,699

Results:

NRG paid franchise fees to the City on a timely basis, but used a lower post-bankruptcy revalued asset basis to compute its franchise fees. However, NRG should use the higher historical cost of its assets since utilities use historical cost for regulatory rate-setting purposes. On a historical cost basis, the gross receipts subject to the City's franchise fees is greater, and NRG owes the City \$80,699 in additional franchise fees for the three-year audit period. NRG concurs with this approach.

NRG's response is attached to the report. The Controller's City Services Auditor Division-Financial Audits will follow up with the San Francisco Public Utilities Commission on the status of the recommendations made in this report.

Respectfully submitted,



Ed Harrington
Controller

INTRODUCTION

BACKGROUND

NRG Energy Center San Francisco LLC (NRG) holds a steam franchise for the City and County of San Francisco (City). NRG is owned by NRG Thermal LLC (NRG Thermal), a subsidiary of NRG Energy, Inc. (NRG Energy). The City's steam franchise ordinance¹ allows NRG to install, construct, maintain, and operate underground steam pipe conduits to carry steam and/or steam condensate for heating and other purposes in the streets, alleys, and other public places within the city.

As payment for the franchise, NRG is to remit annually to the City two percent of NRG's gross receipts subject to the franchise fee. NRG is required to report gross annual receipts subject to franchise fees based on the ratio of the part of the operating plant assets attributable to steam distribution (franchise assets) to the total investment in its operating plant assets.

Under the San Francisco Administrative Code, the San Francisco Public Utilities Commission (PUC) is responsible for administering the City's steam franchise.

SCOPE AND METHODOLOGY

The purpose of this audit was to determine whether NRG correctly reported its gross annual receipts and correctly paid the required franchise fees from January 1, 2003, through December 31, 2005. To conduct the audit, we reviewed the applicable provisions of the ordinance, interviewed NRG and NRG Thermal staff, and reviewed and tested applicable reports and records.

To determine whether NRG correctly reported its gross receipts, we compared the amounts NRG reported to the City to the amounts recorded in its accounting records. We determined, on a test basis, whether NRG correctly billed its customers according to meter reading records, and the rate schedules filed with the California Public Utilities Commission. We also verified that NRG's assets were capitalized according to its policies, were supported in its records, and were correctly classified as franchise or non-franchise assets, and performed other tests we considered necessary.

¹ Ordinance No. 418-75

AUDIT RESULTS

NRG CORRECTLY REPORTED ITS GROSS RECEIPTS, BUT OWES ADDITIONAL FRANCHISE FEES TO THE CITY

From January 1, 2003, through December 31, 2005, NRG Energy Center San Francisco LLC (NRG) correctly reported, in all material respects, \$46,465,546 in gross receipts, and paid franchise fees of \$410,111 to the City on a timely basis. However, NRG underpaid its fees by \$80,699 because it did not use the historical cost of its operating plant assets to compute its franchise fees. NRG agreed that it should use the historical costs to calculate its franchise fees. According to NRG Thermal's chief financial officer, utility companies such as NRG keep historical asset cost records for regulatory purposes, such as to set power rates.

NRG computed the gross annual receipts subject to the two percent franchise fee based on the ratio of its franchise assets to its total operating plant assets. NRG computed this ratio by using the asset values recorded in its accounting records. However, when NRG Energy, the ultimate parent company of NRG, emerged from bankruptcy on December 5, 2003, it significantly revised the value of all its assets. According to NRG Thermal's chief financial officer, NRG Energy and all its subsidiaries were required to revalue their assets upon emergence from bankruptcy. As a result, NRG's operating plant assets were reduced from \$24 million as of December 31, 2002, to \$4.4 million as of December 31, 2003. This revaluation also caused the ratio of NRG's franchise assets to its total operating plant assets to decrease to an average of 45 percent for the audit period compared to an average of 58 percent from 1998 through 2002. The appendix shows the value of the assets during the audit period before and after the revaluation, including the corresponding ratios.

The table below applies the ratios based on historical costs to recalculate the gross receipts subject to the City's franchise fee, and shows that NRG owes the City \$80,699 in additional franchise fees.

TABLE

**NRG Energy Center San Francisco LLC
Gross Receipts and Franchise Fees
2003 through 2005**

Year	Gross Receipts	Ratio of Franchise Assets to Total Investment in Operating Plant	Gross Receipts Subject to Franchise Fees	Franchise Fees Due	Franchise Fees Paid	Additional Franchise Fees Due
2003	\$14,172,309	53.572%	\$7,592,389	\$151,848	\$151,295	\$553
2004	15,246,646	53.175%	8,107,404	162,148	127,517	34,631
2005	17,046,591	51.862%	8,840,703	176,814	131,299	45,515
Total	\$46,465,546		\$24,540,496	\$490,810	\$410,111	\$80,699

RECOMMENDATIONS

To ensure that NRG Energy Center San Francisco, LLC complies with its franchise agreement with the City, the San Francisco Public Utilities Commission should take the following actions:

- Collect from NRG \$80,699 in additional franchise fees.
- Require NRG to continue using the historical cost of its operating plant assets to calculate franchise fees.

We conducted this review according to the standards established by the Institute of Internal Auditors. We limited our review to those areas specified in the audit scope section of this report.

Staff: Ben Carlick, Audit Manager
Edwin De Jesus

Appendix

NRG Energy Center San Francisco LLC Comparison of Revalued Assets and Historical Cost 2003 through 2005

	2003		2004		2005	
	Revalued Asset Amount	Historical Cost	Revalued Asset Amount	Historical Cost	Revalued Asset Amount	Historical Cost
Franchise Assets	\$2,359,261	\$16,520,596	\$2,011,209	\$16,597,323	\$2,576,619	\$17,162,350
Non-Franchise Assets	2,060,739	14,317,743	2,798,214	14,615,233	4,113,847	15,929,754
Total Plant Assets	\$4,420,000	\$30,838,339	\$4,809,423	\$31,212,556	\$6,690,466	\$33,092,104
Percent Franchise Assets	53.4%	53.6%	41.8%	53.2%	38.5%	51.9%

NRG Energy Center San Francisco LLC
RESPONSE TO THE AUDIT:



NRG Thermal LLC
80 South 8th Street, Suite 2600
Minneapolis, MN 55402

Phone: 612.436.4100
Fax: 612.349.6067

December 1, 2006

Mr. Ben Carlick, Audit Manager
City and County of San Francisco
City Hall, Room 476
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102

Re: NRG Energy Center San Francisco LLC
Franchise Fee Audit—Number 05309

Dear Mr. Carlick:

I have reviewed your audit report of the 2003, 2004 and 2005 franchise fees of our subsidiary NRG Energy Center San Francisco LLC. I agree with the determination that, based on use of the historical cost of property plant and equipment, an additional \$80,699 is due for the three years under review in accordance with the franchise agreement.

I also agree with the recommendation that NRG Energy Center San Francisco continue to use the historical cost of its operating plant assets to calculate future franchise fees.

If you have any questions, please call me at 612-436-4106.

Sincerely,

A handwritten signature in dark ink, appearing to read "T. Guglielmi". The signature is fluid and cursive, written over the printed name.

Thomas Guglielmi
Chief Financial Officer

Cc: Peggy Avery
Gordon Judd

cc: Mayor
Board of Supervisors
Civil Grand Jury
Budget Analyst
Public Library

